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Authors

Ben Burston

Forecasting & Strategy Research
+44 (0)20 3296 2296
ben.burston@dtz.com

Matthew Hall

Forecasting & Strategy Research
+44 (0)20 3296 3011
matthew.hall@dtz.com

Contacts

Tony McGough

Global Head of Forecasting & Strategy Research
+44 (0)20 3296 2314
tony.mcgough@dtz.com

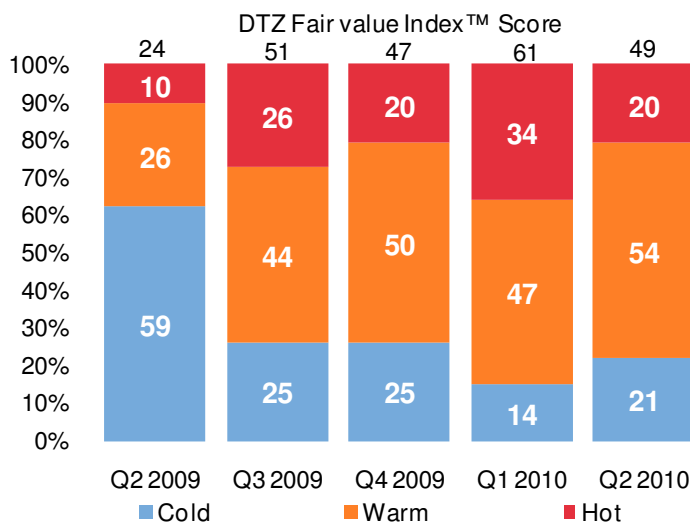
Hans Vrensen

Global Head of Research
+44 (0)20 3296 2159
hans.vrensen@dtz.com

- European property markets are broadly priced at fair value, as indicated by the European all property Fair Value Index™ score of 49 in Q2 2010 (Figure1).
- The European office sector has the highest proportion of COLD markets with an index score of 35 compared to 65 and 57 in retail and industrial respectively.
- European markets have become less attractive than other global markets due to strong yield compression and increased risk premiums in some markets, combined with a sluggish rental growth outlook.
- Europe has corrected ahead of the global index as the recovery of European investor demand created stronger downward pressure on yields. During the H1 of 2010 most European markets saw some downward yield movement.
- The number of European markets classified as HOT (5% or more under-valued) by the DTZ Research Fair Value methodology currently sits at 20, with 21 being classified as COLD (5% or more over-valued).
- Outlook is mixed throughout Europe. Some are well balanced through returning demand and limited supply, (London City Offices, Paris CBD Offices), while others are experiencing falling demand and large supply overhangs (Madrid Offices).
- Regional performance has been influenced by bond yields as much as property outlook. Germany has no markets classed as COLD despite limited forecast rental and capital growth, through low bond yields.
- Although the Nordics, France and UK also have relatively low bond yields, lower rental and capital growth forecasts have presented them as less attractive opportunities.

Figure 1

European All Property Classification and Fair Value Index Progression



Source: DTZ Research

Fair Value Index

The relative safety of Europe highlighted by global picture

- The DTZ Fair Value Index™ demonstrates that all European property has experienced a rapid correction (Table 1). Over the past six months, the index score fell to 49 as the number of HOT markets equalled the number of COLD markets.

Table 1

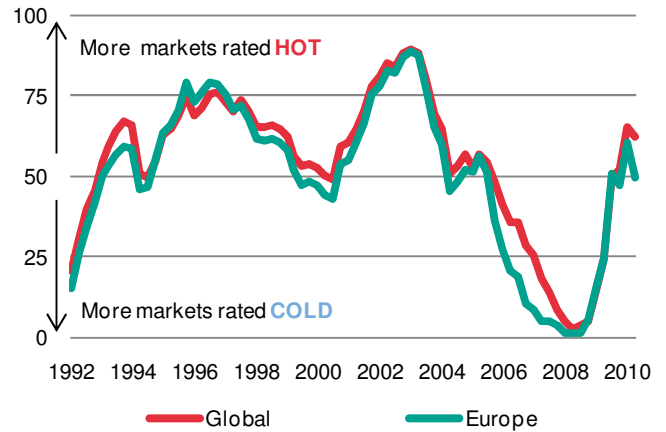
Global Fair Value Index Q2 2009			
Fair Value = 50			
	Q2 2010	Q1 2010	Q2 2009
Europe All Prop	49	61	24
Europe Office	35	46	21
Europe Retail	65	73	42
Europe Industrial	57	70	11
Global All Prop	62	65	24
Global Office	56	60	20
Global Retail	73	72	36
Global Industrial	58	67	14

Source: DTZ Research

- European offices have maintained the lowest index score of the 3 major sectors, and has remained consistently below 50. Both retail and industrial sectors are showing better value with index scores over 50, but they are trending along the same path as the office sector.

Figure 2

Global All Property Fair Value Index



Source: DTZ Research

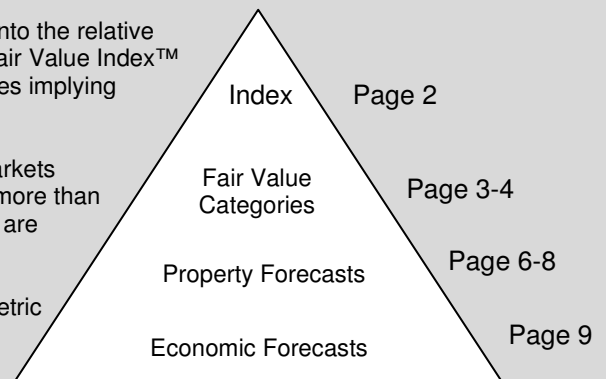
- Although historically European property has closely followed global performance, we have entered a period of divergence. The European Fair Value Index demonstrates a quicker period of price correction in Europe when compared to global performance (Figure 2). There are currently fewer under-priced opportunities in Europe than in Asia Pacific and US.
- Current fundamentals suggest that this has been driven by rapid yield correction as investors rushed to get back in to the market and take advantage of the short window of opportunity where prices represented fair value.

Box 1: Guide to DTZ Fair Value Index™

The DTZ Fair Value Index™ is intended to provide investors with insight into the relative attractiveness of current pricing in global commercial property markets. Fair Value Index™ scores reflect the proportion of HOT and COLD markets, with higher scores implying more HOT markets.

Markets are categorised by comparing expected and required returns. Markets estimated to be more than 5% under-priced are classified HOT; markets more than 5% over-priced are classified as COLD; and, markets between this range are classified as WARM.

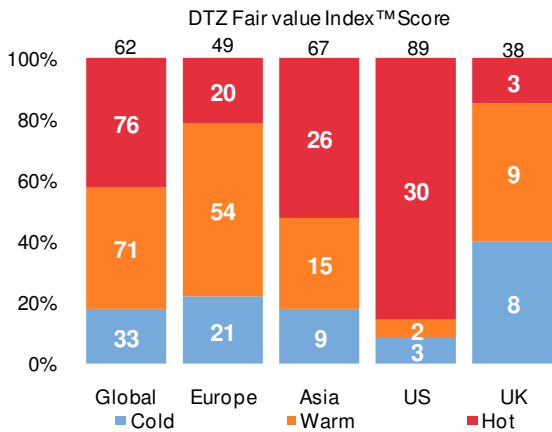
The DTZ Fair Value Index™ is a forward looking index based on econometric forecasts incorporating local econometric drivers and local market knowledge.



For further information on the methodology used for classifying different markets and calculating Fair Value Index scores, see the DTZ Research report: DTZ Fair Value Index™ Methodology

Figure 3

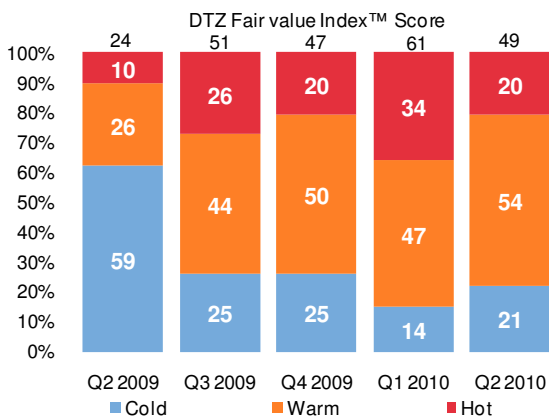
Regional Fair Value Classification Q2 2010



Source: DTZ Research

Figure 4

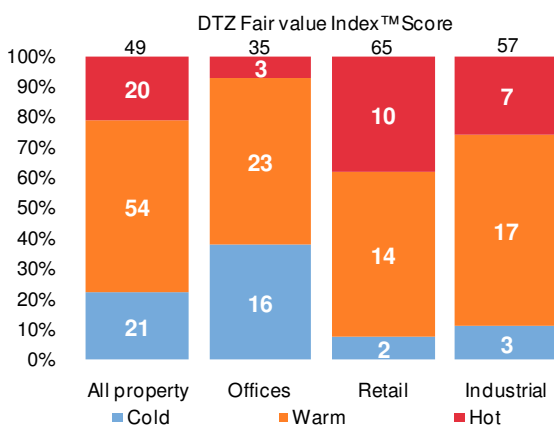
European Fair Value Classification Progression



Source: DTZ Research

Figure 5

European Fair Value Classification by Sector Q2 2010



Source: DTZ Research

European correction ahead of global trend

- European commercial property markets are slightly ahead of the other major regions as the DTZ Fair Value Index Score falls, with only the UK displaying a higher proportion of COLD markets (Figure 3).
- Additionally, only the UK has a smaller proportion of markets classified as HOT. Both Asia Pacific and the US are behind Europe in the correction cycle as most markets are still classified as HOT.

European Fair Value downgrades

- Overall, the proportion of European markets at or above fair value fell slightly by the end of the second quarter due to changes in the economic environment (Figure 4).
- The sovereign debt crisis increased the required rate of return for many countries through two main mechanisms. Firstly, systemic risk increased and secondly, increasing government bonds in others raised required returns, moving previously HOT markets to WARM.
- Despite the overall trend of increasing required rates of return, some countries witnessed slight falls in government bond yields. Core market bond yields fell on previous expectations as markets responded positively to planned budget cuts.

Mixed prospects place DTZ European Retail Fair Value Index well above 50

- European office markets saw an end to improving values. As well as movements in the risk free rate, an end to the yield compression phase of the current cycle has had a large impact (Figure 5).
- Additionally, some markets saw rental increases in Q2 2010, leaving little or no forecast rental growth for the remainder of the year. As a result, the 5 year rental outlook is now weaker than it was last quarter.
- Retail markets are demonstrating large diversity in terms of their fair value classifications. Although many European retail markets are expecting tough times, a large proportion is classified as HOT or WARM (Figure 5).
- The recovery in European retail is behind that in the office sector. For this reason many European retail markets have further yield compression and rental growth to come and are consequently at or above fair value.

Fair Value Top Markets

Relatively high German yields present opportunity

- Europe remains broadly balanced with 20 HOT and 21 COLD markets. There are proportionally more COLD than HOT markets in the Nordics and the UK where yields have begun to firm up and rental growth figures remain largely subdued (Table 2).
- France has no markets classified as HOT, but has a significant proportion classed as WARM – indicating that France is generally well priced. Germany on the other hand has no markets classed as COLD as currently high yields present positive outlook for capital growth.

Some major markets continue to provide buying opportunities

- Among the major European markets, several attractive opportunities still exist (Table 3). Although pricing has closed many of the buying opportunities seen at the end of 2009, some of the more established markets remain well priced.
- London City offices remain one of the most attractively priced markets when size and liquidity are considered. Strong rental growth over the medium term driven by a rapid recovery from the crisis combined with short supply will provide solid capital value growth and consequently attractive returns for investors.

Paris CBD offices move to WARM

- Paris CBD offices are also experiencing a strong recovery, but rental growth is not forecast to be as strong as London City. Until Q2 2010 Paris had been classified as HOT, however, rental growth experienced during the first half of 2010 reduced the level of future growth available and in turn removed scope for capital growth, reducing the level of underpricing.
- In the retail sector, investors are currently able to purchase strong future rental growth in both London West End and Milan. London West End has held up well during the downturn and is forecast deliver stronger growth and Milan is set to deliver a solid rebound after falling significantly.
- Industrial markets have proven to be less volatile throughout the downturn, and whilst the outlook for rental growth is subdued, high yields in Antwerp and Hamburg provide high returns.

Table 2

European Market Classifications Q2 2010			
	HOT	WARM	COLD
EU all prop	20	54	21
EU office	3	23	16
UK all prop	3	9	8
UK office	1	4	7
Germany all prop	3	8	0
France all prop	0	7	2
CEE all prop	5	6	5
Nordic all prop	1	7	5
Rest of Europe all prop	8	17	1

Source: DTZ Research

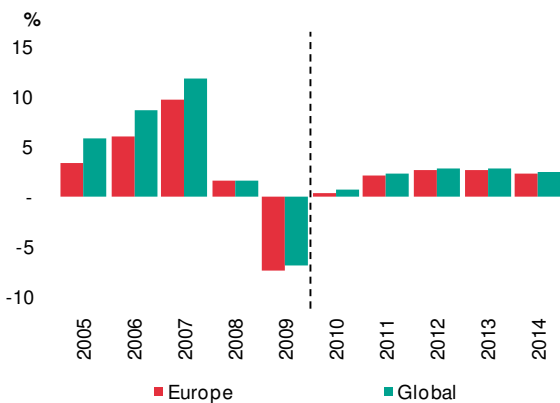
Table 3

Global Fair Value Index Top Markets			
	Market	Category	under/over valuation
Top 5 Office Markets	London City	HOT	-12%
	Paris CBD	WARM	-3%
	Frankfurt	WARM	-1%
	Milan	WARM	-1%
	Madrid	WARM	3%
Top 5 Retail Markets	London West End	HOT	-9%
	Milan	HOT	-6%
	Paris	WARM	-4%
	Munich	WARM	-3%
	Barcelona	WARM	-1%
Top 5 Industrial Markets	Antwerp	HOT	-8%
	Hamburg	HOT	-7%
	Rotterdam	WARM	-3%
	Warsaw	WARM	-2%
	London Heathrow	WARM	2%

Source: DTZ Research

Figure 6

Europe vs. Global All Property Rental Growth



Source: DTZ Research

European rental growth in line with global history and outlook

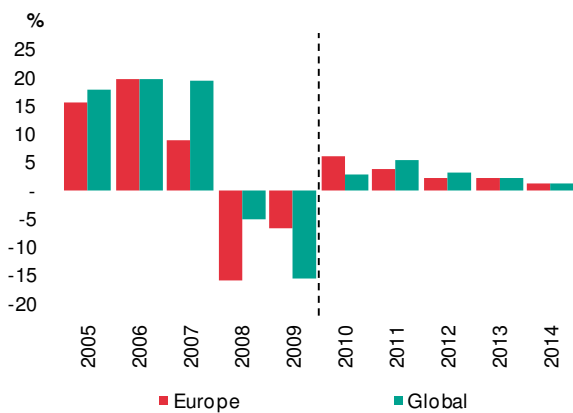
- European rental growth has behaved largely in line with global performance and there is little difference of note between the two (Figure 6).
- Figure 6 clearly demonstrates the stable rental outlook forecast over the next 5 years. Expectations do not accommodate a boom in occupier demand like those seen in the previous cycle.

Capital growth demonstrates that Europe is ahead of the global trend.

- European capital growth demonstrates that Europe was one of the first to experience a slowdown in capital growth as the credit crunch began to bite (Figure 7). Similarly, it was also around 12 months ahead of the global correction.

Figure 7

Europe vs. Global All Property Capital Growth



Source: DTZ Research

- As we have already established that European rental value growth was largely in line with global trends, so we can deduce that the difference in the capital growth results is driven by yields. European yields were swift to react to the global financial crisis and have also driven growth ahead of the curve as well.

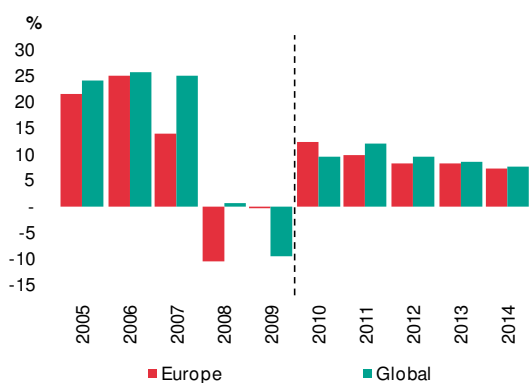
- Capital growth forecasts follow a similar pattern to the rental growth profile, indicating that future capital growth profiles will be largely stable.

European total returns to level out in 2009 and peak in 2010

- Yield compression drove a rapid turnaround in 2009 and delivered total returns of -0.5% when expectations had been for a double digit negative return (Figure 8).

Figure 8

Europe vs. Global All Property Total Returns



Source: DTZ Research

- Continued investor demand has driven relatively strong total returns to be forecast for 2010 with around 12% expected.
- However, although total returns did not reach the depths that were expected and have returned positive ahead of schedule, the cost of this is forecast to be relatively low, stable returns over the forecast period.

European Office Market Forecasts

Office market performance continues to improve as supply constraints take hold

- European office rents showed the sharpest falls in 2009. In 2010 they are expected either to remain flat or to post positive growth.
- Weighted average European rental growth is forecast to reach 2.6% in 2010, following two consecutive years of negative results (Figure 9).
- Supply constraints are dominating performance as the strongest rental growth is anticipated in markets like London City and Paris CBD where the supply of new stock has dried up. Furthermore, the more volatile markets like Moscow and Kyiv are forecast to provide strong performance over the next 5 years after 2 years of significant falls.

Yields stabilizing and reverting towards their long run average

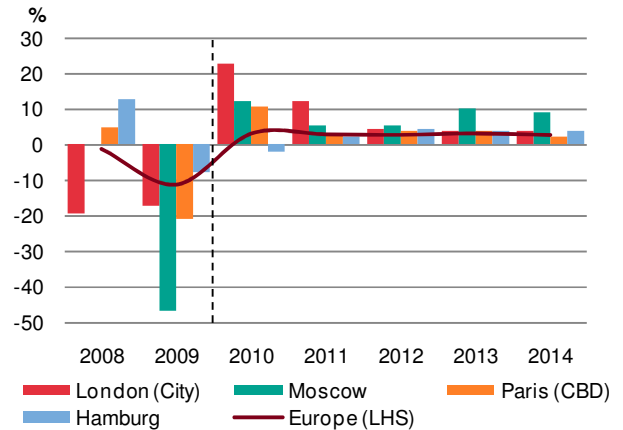
- Investor demand has driven yield compression in many markets, some of which are forecast to reach bottom in 2010. Yield profiles follow two distinct patterns; firstly the established, liquid markets of western Europe that are expected to reach bottom during 2010 and 2011 and rise by the end of the period – and the more volatile CEE markets that are expected to stabilise in 2010 before benefiting from falling risk premiums and strong rental growth to provide continual compression over the next 5 years (Figure 10).
- Low government bond yields have driven the current boom in demand as investors chase returns on their capital. Low risk-free rates increased the relative attractiveness of property by comparison. However, as bonds are forecast to rise over the next two years, so are office yields in markets without rental growth.

Total returns level out over the forecast period

- 2010 is forecast to deliver strong returns on the back of rental growth and yield compression. However, after the over-correction of 2010, yield compression is forecast to stabilize and hence total returns are expected to level out (Figure 11).
- Rental growth also has a significant influence in 2010, but continues to display subdued growth over the forecast period. The austerity measures have had a negative impact on rental growth as many markets expect reduced demand over the next 5 years.

Figure 9

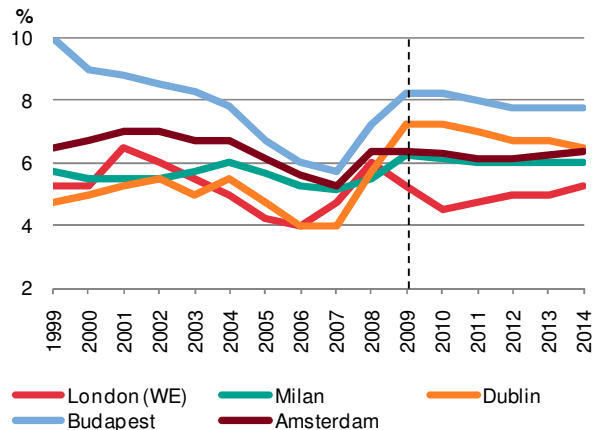
European Office Rental Growth Forecasts



Source: DTZ Research

Figure 10

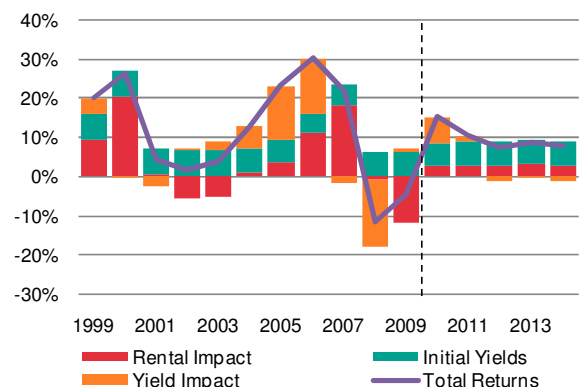
European Office Yield Forecasts



Source: DTZ Research

Figure 11

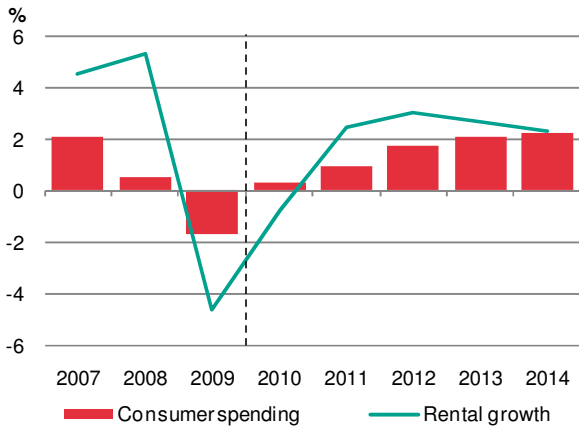
European Office – Components of Total Returns



Source: DTZ Research

Figure 12

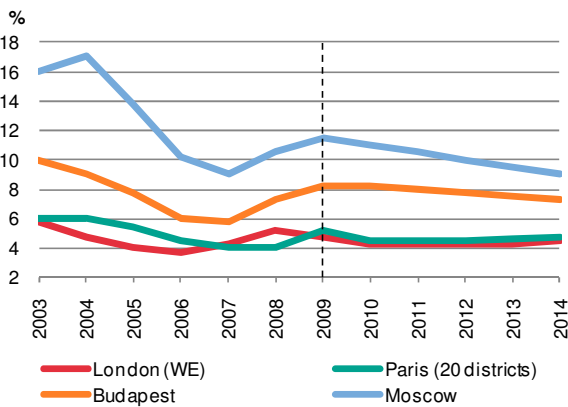
Europe Retail Rental Growth and Consumer Spending



Source: DTZ Research/Oxford Economics

Figure 13

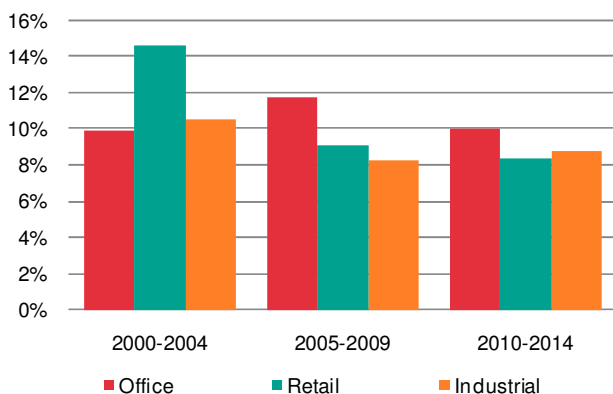
European Retail Yield Forecasts



Source: DTZ Research

Figure 14

European Retail Total Returns



Source: DTZ Research

Sovereign finances to impact retail rental growth

- European retail markets are expecting mixed results over the forecast period. Larger, tourist dominated markets are expecting growth in 2010, while others are still forecasting falls. This results in a weighted average European retail rental growth of -0.76% in 2010.
- As consumer spending increases gradually towards 2014, positive rental growth is expected (Figure 12). However, performance between markets is expected to remain varied as austerity measures impact on disposable income.
- A number of countries announced budget cuts and tax increases to improve their debt position. UK, Germany, Greece etc have all announced public spending cuts to halt the growth of national debt and repair budget deficits run up in the downturn.

Yield compression to continue in 2010 and 2011

- Yield compression has been universal in the retail sector during 2010. Most markets have moved in unison as investor demand grew. Retail markets in developed markets witnessed limited movement, even through the downturn due to consistent investor demand.
- Yield compression is expected to continue in 2011 in most markets but come to halt in 2012. As we go towards 2014 we are likely to see increases towards the long run average. In line with the office sector, yields in some emerging markets like Budapest and Moscow are forecast to continue falling until 2014 (Figure 13) as many markets become more aligned with Western Europe.

European retail sector to deliver the lowest average returns over the forecast period

- European retail property is expected to be the worst performing sector over the forecast period through limited yield compression and low rental growth (Figure 14).
- As rental growth and yield compression level out towards the end of the forecast period, performance will be driven by income returns. In this environment, the low yielding retail sector will fall behind industrial property to deliver the lowest returns.

European Industrial Market Forecast

Industrial outlook deteriorates during Q2 2010

- The European industrial markets are forecast to post a -2.1% weighted average rental growth in 2010. The explanation behind these falls comes from the contraction in distribution, transport and manufacturing GVA. An 8.7% reduction was reported between 2007 and 2009 and with a slow recovery forecast over the next 5 years.
- Growth in the industrial rental markets is expected to return from 2011 onwards. Relative winners over the next five years are expected to be Brussels, Warsaw and Prague, all with above 2% average rental growth (Figure 15).

Varying yield prospects among European markets

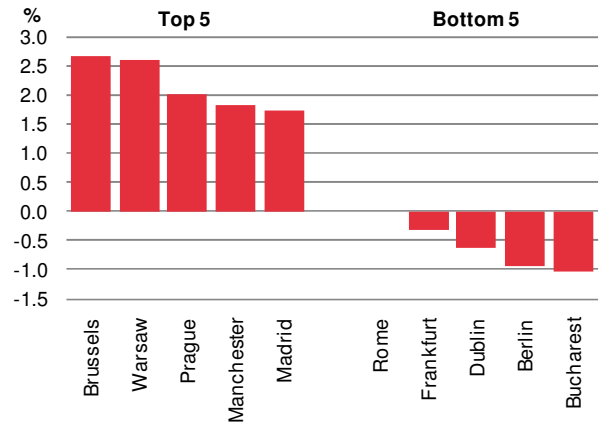
- Similarly to the other two sectors, yield compression has been evident in the industrial sector in most markets since 2009. However the yield profile for the years going forward varies significantly amongst markets.
- In a number of markets - like Rotterdam, Madrid and Rome - yield compression is expected to continue until 2013. In others, yield falls are forecast to end sooner before leveling out towards the end of the forecast period (Figure 16).
- As rental expectations improve in the sector and industrial output increases, more investment demand is expected in later years.

Industrial property delivers stable returns over the forecast period

- Unlike the retail and office sectors, industrial property is forecast to display negative rental impact in 2010. However, this is expected to recover and remain largely positive over the remainder of the forecast period.
- High yields boost relative performance in the later years of the forecast as rental growth and yield compression level out. The result is forecast to be relatively high, stable returns over the next 5 years (Figure 17).

Figure 15

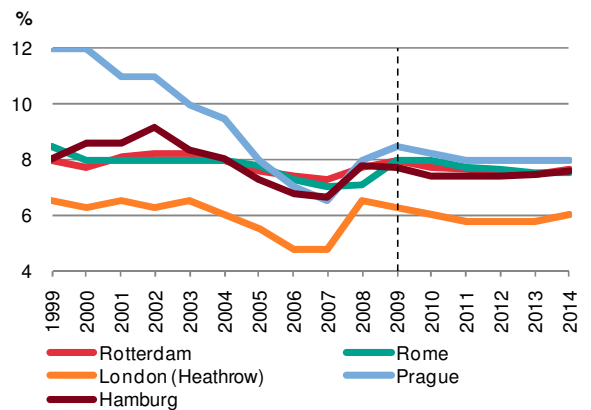
Europe Industrial Rental Forecast Top and Bottom 5



Source: DTZ Research

Figure 16

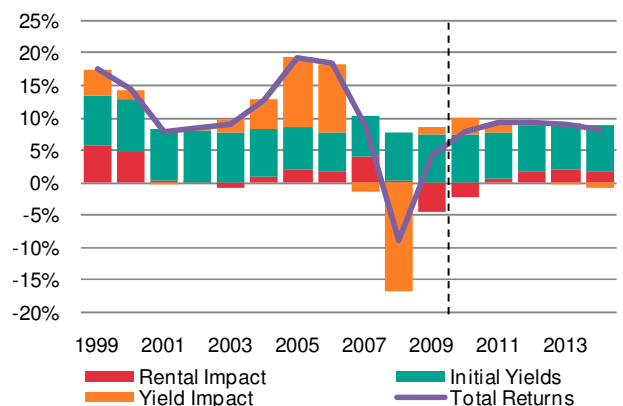
European Industrial Yield Forecasts



Source: DTZ Research

Figure 17

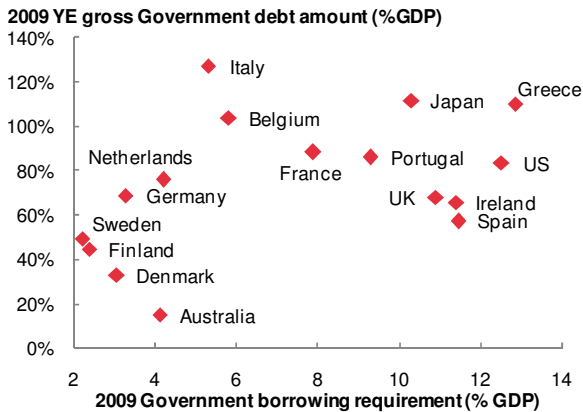
European Industrial Total Returns



Source: DTZ Research

Figure 18

European Sovereign Debt Positions



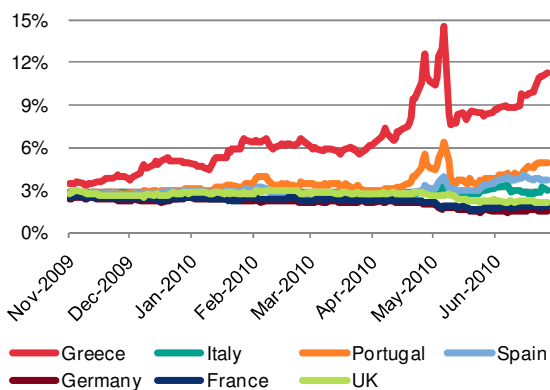
Source: Oxford Economics/DTZ Research

Europe holds its breath as austerity measures bite

- The major story of the current quarter is the austerity measures imposed by many governments in reaction to the sovereign debt crisis. Greece was the early indicator of problems to come as investors lost confidence in the government's ability to repay outstanding bond maturities (Figure 18).
- Falling GDP combined with increasing government spending saw investors undertake a flight to quality in the bond markets leaving Greek bonds to suffer yield decompression. The crisis has drawn in several European countries (Portugal, Ireland, Greece and Spain) as investors have concerns over those countries and their ability to pay their debts (Figure 19).

Figure 19

European Government Bond Yields



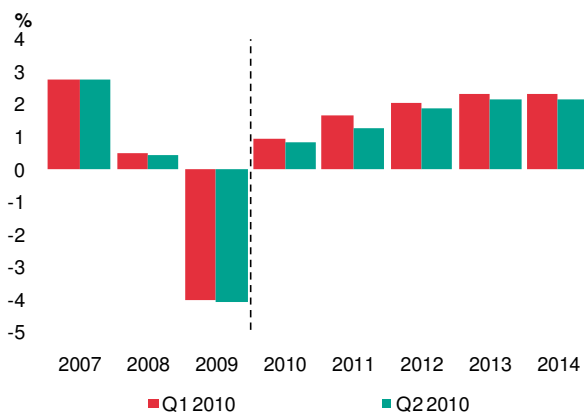
Source: Oxford Economics

Sovereign debt control measures appear to effect GDP forecasts

- As well as impacts in bond markets, addressing the growing national debt crisis across Europe has also driven a revision to national output forecasts. An end to Keynesian economics as governments attempt to gain control over budget deficits has caused a downward revision in GDP forecasts (Figure 20).
- Romania is a particularly extreme example of sweeping austerity measures where 25% reduction of state salaries and 15% reduction in pensions have been implemented.
- Along with downgrades to GDP forecasts, public spending cuts are also expected to have a significant downside effect on retail spending and consumption as a whole. Public sector workforces are going to find disposable incomes cut and are going to demonstrate a reduced propensity to consume. The DTZ view is that there is more downside that has not yet been incorporated in the retail drivers.

Figure 20

European GDP Revisions



Source: Oxford Economics

All eyes are on public sector dominated markets as spending cuts begin to take shape.

- Long term concerns are developing for markets dominated by public sector employment. Although budget cuts are currently in the planning stage, percentage cuts in the region of 40% are being announced.
- Cuts of this magnitude will have a significant impact on many markets and the DTZ view is that there may be further downside to economic drivers in all three sectors.

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